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ELABORATION OF BASIC ELEMENTS FOR CONSIDERATION IN FORMULATING PRIVATIZATION PROGRAMMES AND PLANS

Indicative elements for consideration in formulating privatization programmes

Note by the UNCTAD secretariat

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INTRODUCTION

1. These indicative elements have been drawn essentially from the exchanges of national experiences undertaken by the Ad Hoc Working Group on Comparative Experiences with Privatization. An attempt has been made to list the main elements which can provide guidelines and options for the formulation of privatization programmes and which Governments or privatization agencies may use, as appropriate, taking into account their particular country situations and experiences.

I. GENERAL CONSIDERATIONS

A. Meaning of privatization

2. Privatization is part of a process of structural adjustment. It involves redefining the role of the State by disengaging the State from those activities which are best done by the private sector, with the overall objective of achieving economic efficiency. It is first and foremost a political process, although it has to be carried out as an economic exercise.

3. Privatization may involve: (a) non-divestiture options - corporatization, the privatization of management (management contracts, leasing and concessions) and the contracting out of public services; and (b) divestiture options - the privatization of capital. A particular form of privatization is the private development of infrastructure.

4. Privatization may be sequenced by going from non-divestiture (for example, corporatization or management privatization) to divestiture options.

B. Conditions for success

5. Steps that the Government can take:

(a) Making a firm political commitment to privatization and to strengthening the role of the private sector in the national economy;

(b) Clarifying and defining (and, as appropriate, resolving any conflicting) political, economic and social objectives;

(c) Building up a broad-based consensus among the parties affected by privatization (bureaucrats, managers, workers, etc.) and in the public at large;

(d) Promoting competition in the economy;

(e) Establishing a clear and transparent legal framework for privatization;

(f) Establishing an effective machinery, with clear mandates and adequate technical and financial resources, for preparing and managing the privatization process;

(g) Encouraging and creating a supportive enabling environment, including favourable macroeconomic conditions, a well-functioning legal system and adequate financial markets and institutions, for private sector and enterprise development, as well as for job creation;

(h) Establishing a social safety net.

C. Privatization strategy

6. A well-designed privatization strategy can help to give credibility and guidance to the process. The strategy needs to address the issues of concern to employees and managers, as well as consumers, that arise from a fundamental change in the role of the State in relation to the promotion of industrialization, the creation of employment and the provision of infrastructure or social services. Steps that can be taken include:

(a) Defining the broad extent of privatization;

(b) Stating clearly the political, economic and social objectives to be achieved;

(c) Establishing clear guidelines or criteria for valuation; the choice of public enterprises for privatization; and for the choice of buyers;

(d) Selecting techniques and, as necessary, their sequence appropriate to the policy objectives to be attained and the needs of the public enterprises to be privatized; creating confidence in the process, for example by starting with privatizations with a high prospect of success; promoting effective corporate governance, for example through the participation of "core" investors;

(e) Ensuring transparency and accountability in the privatization process; using competitive bidding to the fullest extent possible, for both non-divestiture and divestiture options;

(f) Mounting a programme to promote public awareness of the value of privatization to the economy so as to contribute to the building up of a broad-based consensus;

(g) Building marketing up front in each privatization operation in order to stimulate potential interest among investors and thus to enhance the value of the public enterprise to be privatized; remembering that, apart from "small privatizations", no two privatizations are the same;

(h) Promoting popular participation in the privatization process through the allocation of a proportion of corporate shares to small investors ("popular capitalism") or through mass privatization;

(i) Addressing the concerns of employees by paying particular attention to their acquired rights, compensation measures for retrenched workers and to employment protection and job creation measures, as reflected, for example, in the investment and social plans of investors;

(j) Promoting employee participation in the privatization process through the allocation of a proportion of corporate shares, either free or at a discount, to employees ("labour capitalism"); allowing for employment share ownership plans, management or employee buy-outs;

(k) Addressing the concerns of consumers through appropriate regulation of privatized monopolies and machinery to handle consumer complaints;

(l) Taking steps, for example by specifying conditions in sales agreements, in order to prevent abuses such as unauthorized transfers to third parties of privatized enterprises immediately after their divestiture;

(m) Defining the role of foreign participation with regard to large-scale or strategic enterprises;

(n) Providing for safeguards (such as the use of "golden share") in strategic enterprises in order, for example, to prevent hostile takeovers; and

(o) Establishing mechanisms or procedures for monitoring the progress and results of privatization, including compliance with commitments made by private investors.

II. FORMS OF PRIVATIZATION

A. Non-divestiture options

1. Types of non-divestiture options

7. Non-divestiture options can help to create the necessary political will and to advance the privatization process by demonstrating the commercial viability of public enterprises. They may serve as important measures in themselves or as preparatory steps to divestiture. Such options include:

(a) Management privatization, including management contracts, leasing and operating concessions;

(b) Restructuring and commercialization or corporatization, to be combined with management privatization, as desired or necessary;

(c) Contracting out of public services.

2. Measures to enhance the performance of public enterprises

8. The measures that can be taken to improve the performance of public enterprises, whether corporatized or not, include:

(a) Establishing performance agreements with specific targets;

(b) Removing subsidies (if subsidies to meet social or non-commercial objectives are needed, they are to be paid for separately and made transparent);

(c) Establishing a performance evaluation system;

(d) In the case of a management privatization with a sales option, agreement on the option in order to give an incentive to the contractor or lessee to improve the efficiency of the public enterprise; and

(e) Exposing the public enterprises to competition or the threat of competition.

3. Restructuring

9. Restructuring, together with a financial audit, can help to establish the assets and liabilities of a public enterprise. The restructuring of a public enterprise can take the form of:

(a) Organizational and labour restructuring, involving re-organization of the public enterprise into more rational or smaller units and any necessary labour shedding;

(b) Financial restructuring or rehabilitation, involving the writing off of excessive debts of the public enterprise;

(c) Operational restructuring, involving the infusion of new investment or technology into the public enterprise.

10. Successful organizational and financial restructuring can help to put the public enterprise on a sound financial and commercial footing, whether it is to be divested or not. Together with successful corporatization, it can help to enhance its sale value when it is to be divested.

11. Where the public enterprise is to be divested, operational restructuring is to be avoided and left to the buyer to undertake.

12. Restructuring is to be avoided where a public enterprise can be sold "as is".

B. Divestiture options

1. Types of divestiture options

13. Divestiture options include:

(a) Direct sale, full or partial, to general investors;

(b) Private placement with "strategic" investors or to joint venture partners;

(c) Public share offerings on stock markets (usually for profitable, large-scale public enterprises);

(d) Public auctions (usually for small or medium-sized public enterprises which do not require technology transfer);

(e) Sales to employees or management teams through employee share ownership plans, management or employee buy-outs ("internal privatizations");

(f) Sales to investment or mutual funds;

(g) Mass privatization;

(h) Liquidation, followed by the sale of assets (where the latter can fetch a higher price than the sale of the entire enterprise or where it may be necessary because of excessive strain on the budget).

14. Once a political decision has been taken on a sale, it should be carried out quickly since the longer the delay the greater is the risk that the assets will deteriorate or that the price will fall.

2. Valuation

15. Where capital markets are deficient, competitive bidding gives market forces a say in the valuation of public enterprises to be sold. Bidding can also help to determine where the valuable assets are located, for example in the case of large-scale public enterprises.

16. Valuation is necessary where there is only one potential buyer.

3. Underwriting

17. Underwriting involves a cost. It may be necessary to insure against the risk of under-subscription, for example, where the public enterprise is not attractive to investors or where the share issues are large in relatively weak or bearish capital market.

18. However, it is to be avoided where the shares are so popular that there is every prospect of over-subscription.

C. Privatization of infrastructure

1. Forms of privatization of infrastructure

19. The privatization or private development of infrastructure may involve:

(a) Sale of the infrastructure;

(b) Sale of the infrastructure company through public flotations or to a private investor;

(c) Granting of an operation or maintenance contract;

(d) Sale of development rights through build-operate-transfer schemes;

(e) Sale of ownership and development rights through build-own-operate schemes.

20. Restructuring, together with corporatization, can help to prepare an infrastructure company for sale and to enhance its sales value.

2. Private development of infrastructure

21. The particular characteristics of the private development of infrastructure (substantial up-front investments with small initial revenue streams and long payback periods, combined with monopoly power) create a unique set of incentives and risks for the private sector developer/operator.

22. Monopoly power can be bestowed by the market, i.e. where demand and cost/technological conditions or the small size of the market serve as effective barriers of entry, or granted for a defined period by a contractual concession as part of the incentives to be provided to the private sector developer/operator.

23. Governments may share the risks with the private sector developer/operator. Alternatively, the risks may be assumed fully by the latter and reflected in the tariffs to be charged by it for the use of the infrastructure. Any subsidies to be provided to the private sector developer/operator, for example to meet social objectives, are to be made explicit and transparent.

24. Loan guarantees from the Government or from multilateral financial institutions may be necessary to obtain the necessary financing.

25. Competitive bidding is necessary for the award of development (and ownership) rights and operating concessions. Pre-selection of bidders is essential for this purpose.

26. There may be a role for the donor community to reimburse partially the pre-selected bidders for their bidding costs and to co-finance the cost of feasibility studies in order to enhance the participation of local bidders.

III. FRAMEWORK FOR PRIVATIZATION

A. Supportive environment

27. A supportive enabling environment for privatization and private sector development can facilitate the success of privatization in its implementation and post privatization phases. Political and social stability are necessary in this regard. In addition, steps can be taken to improve the economic, financial and legal aspects. These include:

(a) Creating favourable macroeconomic conditions, including through the promotion of economic liberalization and deregulation and the achievement of monetary, fiscal and exchange rate stability, in order to generate investment, including foreign investment, growth and employment;

(b) Providing adequate infrastructure;

(c) Promoting measures to encourage or facilitate private investment or enterprise development, including measures to attract foreign investment; to mobilize domestic savings through improved financial intermediation, both

formal and informal; to reduce public sector borrowing requirements, for example by improving the tax base, through tax reforms and better tax collection; and to provide support, such as support for access to credit, for micro, small and medium-sized business development;

(d) Creating conditions in which the local private sector can compete on equal terms with foreign investors.

(e) Simplifying and deregulating administrative procedures for the development of entrepreneurship and of enterprise development;

(f) Establishing laws and regulations for the development of the private sector and of financial markets and institutions, including inter alia business laws (property rights, contract laws, the constitution and operation of companies, accounting and auditing procedures, bankruptcy and liquidation procedures) and laws on financial institutions and markets, foreign direct investment, joint ventures, as well as on legal enforcement procedures.

B. Legal framework and machinery for privatization

1. Privatization laws

28. Such laws may include:

(a) The legal framework, including the machinery, for privatization;

(b) The preparation and methods of privatization, including the legal status of public enterprises, the Government employees concerned, their pension funds, severance payments, etc.

(c) The procedures and conditions of privatization;

(d) Competition and regulation issues and authorities for privatized monopolies.

2. Privatization machinery

29. An effective central machinery, under the guidance of a political authority (the Prime Minister or the Cabinet, for example) and vested with clear mandates and adequate technical and financial resources, needs to be established for preparing and managing the privatization process, including the coordination of policy and of implementation and the preparation of privatization plans and programmes.

30. The implementation of privatization operations may be undertaken by the central agency or may be decentralized to sectoral Ministries or other designated bodies, depending on where the balance of cost efficiency lies.

C. Competition and regulation

1. Promotion of competition

31. The promotion of competition is central to the success of privatization. While ownership often matters, competition matters even more for the achievement of efficiency gains.

32. Competition may be promoted through competitive market structures and appropriate liberalization and competition policies.

33. In the case of public utilities, pro-competition regulation and a liberal licensing policy are important. Contestable sectors may be separated from the "natural monopoly" carrier network or grid, and the former exposed to competition. Grid-based services may be open to competition by licensing access to the grid to competitive suppliers.

34. A network "natural monopoly" exists where the demand and cost/technological conditions or the small size of the market serve as effective barriers to entry. However, where competition is possible, network competition may be promoted by licensing rival networks.

2. Regulation

35. In a monopoly industry, regulation is necessary in order to protect consumer welfare and to promote the efficient functioning of the industry by fostering financial stability and viability and by providing incentives for innovation and efficiency.

36. Forms of economic regulation include:

(a) Price regulation;

(b) Rate of return regulation; and

(c) Negotiated contractual concession.

37. The steps that Governments can take for the regulation of public utilities include:

(a) Establishing a clear regulatory framework for regulating each public utility with well-defined rules of the game for all the parties concerned (the State, the service provider and consumers);

(b) Establishing the regulatory framework and the regulatory authority before privatizing the public utility;

(c) Creating market structures to allow for maximum competition;

(d) Creating competent regulatory authorities and ensuring their independence from political interference;

(e) Ensuring that the procedures used by the regulatory authorities are transparent and that their decisions are made public;

(f) Rationalizing the structures for related industries, e.g. those belonging to a particular sector such as energy, in order to keep the number of regulatory bodies to a minimum.

38. A negotiated contractual concession may be used where the regulatory capacity is not adequate or is subject to political interference. In such a situation, a contractual concession may be more attractive to the private sector developer/operator than price or rate of return regulation. Monitoring of security and quality of service may be needed.

IV. SOCIAL IMPACT AND SUPPORT MEASURES

A. Social considerations and assessment

39. Social considerations are an essential component of the process of privatization and need to be built into the process from the beginning and reflected in the strategy for privatization.

40. The effects of privatization on employment and consumer welfare need to be addressed. However, the social balance sheet of privatization goes beyond such effects. It will also have to take into account the effects of privatization on investment and growth, income and wealth distribution, and on the provision and cost of infrastructure and social services arising from the privatization of public utilities and social services.

41. Social subsidies provided, for example, for the supply of services to rural areas, are to be made explicit and transparent.

42. Internal privatizations, including employee share ownership plans, management or employee buy-outs, can provide incentives to employees to improve productivity and to promote the long-term viability of the enterprises.

B. Job security

43. Job security in the privatized enterprises may be promoted through generally-applicable measures to protect employment and its conditions for a specified period after privatization or through enterprise-specific investment and social plans of investors or a combination thereof.

44. If any labour restructuring is to be undertaken, it may be handled better by the Government before divestiture, with appropriate compensation measures, than by the private investor after divestiture. A balance needs to be struck between the concern to guarantee employment through contractual arrangements and the need to ensure the viability of the privatized enterprises, which is an essential part of job security.

C. Support measures

45. Socially-related support measures may include:

(a) Compensation measures, including redundancy or severance packages;

(b) Voluntary early retirement schemes, together with compensation measures;

(c) Measures to improve skills and job mobility through retraining and vocational training, job counselling, assistance for relocation, etc.;

(d) Job creation measures through the promotion of entrepreneurship and of micro, small and medium-sized business development.

46. Compensation measures should be designed so as to take into account not only the interests of the employees but also the larger interests of society as a whole. In particular, they should not be so generous as to induce massive departures from the privatized enterprises or to provide obstacles to future privatizations.

47. A social safety net, with clear principles spelt out from the beginning, can help to cushion any negative effects of privatization and to win support for the privatization process.

48. Socially-related support measures, together with a social safety net, may be financed from different sources. Apart from using part of the proceeds of privatization for this purpose, loans may also be obtained from multilateral financial institutions.

49. Support for job-creation measures may also be provided through fiscal and regulatory reforms in order to improve the access of micro, small and medium-sized businesses to resources and markets, as well as through policies to improve financial intermediation, both formal and informal, for such businesses.

50. Entrepreneurs in the informal sector can sometimes compete successfully with businesses in the formal sector. Helping successful businesses in the informal sector to graduate to the formal sector can contribute to improved competition and tax revenue for the State.